Office of Chiet ⌣⌣unsel
Internal Revenue Service

memorandum

CC:WR:SCA:LN:TL-N-6290-98
JSHargis

date: July 16, 1999

to: Chief, Examination Division, Southern California District
Dane Harrison, E:1105; Susan Downing, E:1410

from: Southern California District Counsel, Laguna Niguel
June Y. Bass, Assistant District Counsel
J. Scott Hargis, Attorney JSH

subject: [redacted]--**Request for Relief under I.R.C. section 1341--round two**

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Whether [redacted] may obtain the benefit of I.R.C. § 1341 with regard to payments made to settle litigation brought by former distributors of its products.

CONCLUSION

[redacted] may not obtain the benefit of section 1341 because the payment was not a payment of the same item previously included in income.

FACTS

District Counsel previously issued advice on this issue in December of 1998. The taxpayer has submitted a protest to the agent's denial of their claim for relief under the mitigation provisions. We have reviewed the protest and our response has not changed.

Between [redacted] and [redacted], [redacted] maintained distributorship agreements with several unrelated companies. These unrelated companies bought [redacted]'s [redacted] and resold them to the public. Subsequent to the termination of some of the distributorship agreements, the former distributors brought suit accusing [redacted] of violating the terms of its contracts with them by essentially "playing favorites" among the distributors. [redacted] was alleged to have allocated more [redacted] to some distributors than it should have under the contracts during a period of high demand for [redacted] products. The plaintiffs alleged that, as a result, they lost sales. [redacted]'s income, on the other hand, did not increase as a result of the alleged unfair sales practices. [redacted] sold as many [redacted] as it could produce during that period and it sold them for set prices. The prices were unaffected by the alleged unfair sales practices. [redacted] was not distributing more [redacted] to the highest bidder.

[redacted] settled the litigation [redacted]. [redacted] made payments to the plaintiffs of $[redacted] during the fiscal year ending September 30, [redacted], and $[redacted] during the fiscal year ending September 30, [redacted]. During the litigation, the parties used experts in an attempt to estimate the profits lost by the dealers as a result of [redacted]'s alleged practices.

ANALYSIS

Generally, section 1341 attempts to minimize the tax effects when a taxpayer includes an item of income in one year and then has to repay it in a later year. The section attempts to achieve this result by taxing the taxpayer the lesser of the current year's tax with the deduction or the current years tax without the deduction minus the amount of tax paid on the item when it was included in income in the prior year. In other words, the taxpayer gets the benefit of the deduction or the exclusion of the income in the earlier year, whichever is greater. In order to obtain the benefits of section 1341, however, the following requirements must be met:

(i) there was an item of income included in gross income in a prior taxable year;

(ii) the inclusion occurred because the taxpayer appeared to have an unrestricted right to the item;

(iii) in a later year, the taxpayer is entitled to a deduction;

(iv) the deduction is allowed because it was established after the close of the year of inclusion that the taxpayer did not have an unrestricted right to the item; and

(v) the amount of the deduction exceeds $3,000. Section 1341(a).

Without repeating the authorities cited in our earlier memorandum, we point out that to take advantage of this statute the item disgorged must be the <u>same item</u> that was earlier included in income. This requirement is statutory. The taxpayer's protest misstates the law as well as the Service's position.

The protest states that it is the Service's position that the payments are not directly connected to an item previously reported. The Service's position is that the payment has to be same item as that previously reported. Degrees of connection are not relevant. Either it is the same item, or it isn't. The taxpayer's statement of the requirements of the statute conveniently leaves out the repetitive references to "such item." All of these references are to the item that was included in income in the first place.

The taxpayer's attempts to distinguish the cases are flawed. The taxpayer's mistaken view of the law is applied to support the argument that there is more of a connection between the payments at issue in its case than there were in the cases cited in the agent's report. This argument is fatally flawed because the premise is incorrect. The issue is not the degree of connection; the issue is whether the items are the same. The cases simply establish this point and one of them, <u>Uhlenbrock v. Commissioner</u>, 67 T.C. 818 (1977), (executor's reimbursement of an estate's late filing penalty is not a repayment of commissions previously included in gross income and would have been required even had no commissions been received, thus section 1341 does not apply) is directly on point.

Section 1341 is referred to the claim of right doctrine. The requirement that the item be the same is part of this doctrine. The payment does not come within the section 1341 if the taxpayer is not disgorging because it turned out that the claim of right was incorrect. Payment or repayment of a connected item does not depend on whether or not the taxpayer's claim of right to another item was valid. See Rev. Rul. 58-226, 1958-1 C.B. 318.

The payments made by [redacted] in settlement of its litigation with its former distributors resulted from the same contract as did the earlier payments but do not represent the same item. In fact, the two are wholly unconnected in the sense that one is not determinative of the other and one is not a repayment (or a payment over to the rightful recipient) of the other. As was the case in Uhlenbrock, [redacted] would have had to pay these damages to the distributors regardless of the amount of payments received from the distributor or the net profit from those payments. The damage payments represent the profits the dealers would have made but did not because of [redacted]'s allocation practices. If anything, the damages represent the income of the other distributors who received a greater number of [redacted] for resale than perhaps they should have. Put simply, [redacted] is not disgorging the same item previously included in gross income.

CONCLUSION

Section 1341 does not apply to these payments. The payments do not represent a payment of the same item previously reported. The two are different items and are not co-determinative.

We are closing our file on this matter and should you have any questions, please contact Attorney Scott Hargis at ext. 3463.

Office of Chi[illegible] ounsel
Internal Revenue Service

memorandum

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date: September 29, 1998

to: Chief, Examination Division, Southern California District
Dane Harrison, E:1105; Susan Downing, E:1410

from: Southern California District Counsel, Laguna Niguel
June Y. Bass, Assistant District Counsel
J. Scott Hargis, Attorney

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subject: [redacted]--**Request for Relief under I.R.C. section 1341**

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ISSUE

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CONCLUSION

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FACTS

Between [redacted] and [redacted], [redacted] maintained distributorship agreements with several unrelated companies. These unrelated companies bought [redacted]'s [redacted] and resold them to the public. Subsequent to the termination of some of the distributorship agreements, the former distributors brought suit accusing [redacted] of violating the terms of its contracts with them by essentially "playing favorites" among the distributors. [redacted] was alleged to have allocated more [redacted] to some distributors than it should have under the contracts during a period of high demand for [redacted] products. The plaintiffs alleged that, as a result, they lost sales. [redacted]'s income, on the other hand, did not increase as a result of the alleged unfair sales practices. [redacted] sold as many [redacted] as it could produce during that period and it sold them for set prices. The prices were unaffected by the alleged unfair sales practices. [redacted] was not distributing more [redacted] to the highest bidder.

[redacted] settled the litigation [redacted]. [redacted] made payments to the plaintiffs of $[redacted] during the fiscal year ending September 30, [redacted], and $[redacted] during the fiscal year ending September 30, [redacted]. During the litigation, the parties used experts in an attempt to estimate the profits lost by the dealers as a result of [redacted]'s alleged practices.

ANALYSIS

Generally, section 1341 attempts to minimize the tax effects when a taxpayer includes an item of income in one year and then has to repay it in a later year. The section attempts to achieve this result by taxing the taxpayer the lesser of the current year's tax with the deduction or the current years tax without the deduction minus the amount of tax paid on the item when it was included in income in the prior year. In other words, the taxpayer gets the benefit of the deduction or the exclusion of the income in the earlier year, whichever is greater. In order to obtain the benefits of section 1341, however, the following requirements must be met:

(i) there was an item of income included in gross income in a prior taxable year;

(ii) the inclusion occurred because the taxpayer appeared to have an unrestricted right to the item;

(iii) in a later year, the taxpayer is entitled to a deduction;

(iv) the deduction is allowed because it was established after the close of the year of inclusion that the taxpayer did not have an unrestricted right to the item; and

(v) the amount of the deduction exceeds $3,000. Section 1341(a).

The statute refers to "the item" throughout but does not define that term. Usually, when a statute includes a common, ordinary term without defining its meaning, the term is to be given its common, ordinary meaning. Webster's dictionary defines "item" as: "A single, separately specified article or unit included in an enumeration, collection or series." Webster's II, New Riverside University Dictionary, 1988. The third definition given by that dictionary is: "[a]n entry in an account."[1] From these definitions it appears that the taxpayer has to disgorge money attributable to a particular transaction in an earlier year. This interpretation is reinforced by the statutory requirement that the disgorgement follow a determination that the taxpayer's treatment of the income in the earlier year was erroneous. It is also reinforced by the reference in the statute to the establishment that the taxpayer did not have an unrestricted right to "such item." Section 1341(a)(2). The regulations reinforce this interpretation by limiting the recomputation of the previous taxable year's tax liability to no more than the amount that was included in the previous taxable year's gross income by reason of the item subject to the claim of right. Treas. Reg. § 1.1341-1(d)(2)(i). Case law also supports this interpretation by denying the benefit of the statute in situations where the payment in a later year was not a payment of the same item.

In Uhlenbrock v. Commissioner, 67 T.C. 818 (1977), the Tax Court held that section 1341 was not available for an executor's reimbursement of an estate's late filing penalty because the reimbursement was not a repayment of commissions previously included in gross income and would have been required even had no commissions been received.

In Smith Est. v. Commissioner, 110 T.C. No. 2 (1/12/98), the court held that an estate could not use section 1341 with respect to portions of a settlement it paid that represented royalty interests inherited, but not personally received and reported, by the decedent. The decedent had been the heir of her two aunts. All three had held royalty interests in oil and gas property and received and reported royalty payments. In 1988, after the death of one of her aunts in 1979, decedent and the other aunt (along

[1] A Dictionary of Accounting, Oxford University Press, 1995, does not give a definition for "item."

with other owners) were sued by Exxon claiming that it had overpaid royalties from 1975 to 1980. The other aunt died in 1989, and the decedent became the heir to her estate as well. Decedent died in 1990. In 1992 her estate settled the litigation, paying more to Exxon than the decedent had personally received and reported. The excess represented repayment of royalties received and reported by the two aunts (and the estate of one of them). The court allowed the application of section 1341 only to the portion of the settlement payment that represented a repayment of the royalties actually received and reported by the decedent, rather than her aunts.

In Kraft v. United States, 991 F.2d 292 (6th Cir.), *cert. denied,* 114 S. Ct. 467 (1993), the Sixth Circuit held that a doctor who had benefitted from false insurance claims was not entitled to the benefit of section 1341. The court explained that the doctor never had an unrestricted right to the money. The court also pointed out that Section 1341 did not apply because the restitution payments did not arise from the same circumstances as the original receipt of income: The item originally included in income was the doctor's salary, whereas the restitution payments derived from the fraudulent insurance claims submitted by the corporation.

Section 1341 does not apply if the taxpayer included the income under an absolute right and makes the repayment for reasons other than a determination that no right existed. See Rev. Rul. 58-226, 1958-1 C.B. 318. Thus, Section 1341 does not apply if the repayment arises because the amount of receipt was in error or because of a repayment liability that arises from a subsequent event.

The payments made by [redacted] in settlement of its litigation with its former distributors resulted from the same contract as did the earlier payments but do not represent the same item. In fact, the two are wholly unconnected in the sense that one is not determinative of the other and one is not a repayment (or a payment over to the rightful recipient) of the other. As was the case in Uhlenbrock, [redacted] would have had to pay these damages to the distributors regardless of the amount of payments received from the distributor or the net profit from those payments. The damage payments represent the profits the dealers would have made but did not because of [redacted]'s allocation practices. If anything, the damages represent the income of the other distributors who received a greater number of [redacted] for resale than perhaps they should have. Put simply, [redacted] is not disgorging the same item previously included in gross income.

[redacted] places a great deal of reliance on Killeen v. United States, 11 A.F.T.R.2d 1072 (S.D. Cal. 1963). That case involved a joint production and sale agreement between the designer of a product and a manufacturer. The manufacturer was to manufacture and sell the product and split the profits with the designer. The designer eventually discovered that the profits were not being split with him in accordance with the agreement. He was able to force the manufacturer to disgorge the profits wrongfully retained. The manufacturer had reported the profits it had retained, including those it should have paid over to the designer. Section 1341 was held to apply. This case does stand for the proposition that the payment need not be a repayment to the original payer, which seems like a correct interpretation of the statute. It also stands for the proposition that the prohibition in section 1341(b)(2) against the application of section 1341 to income items arising out of the sale of inventory items should be limited to sales returns, allowances and similar items. See also section 1.1341-1(f). Nevertheless, the case clearly involves payment of the same item previously included in income. Therefore it is inapposite to the case at hand, which clearly involves a payment that is a different item from that included in income.

CONCLUSION

Section 1341 does not apply to these payments. The payments do not represent a payment of the same item previously reported. The two are different items and are not co-determinative.

We are closing our file on this matter and should you have any questions, please contact Attorney Scott Hargis at ext. 3436.

Attachments
<u>Uhlenbrock v. Commissioner</u>, 67 T.C. 818 (1977)
<u>Smith Est. v. Commissioner</u>, 110 T.C. No. 2 (1/12/98)